I. ECONOMIC ENVIRONMENT

(1) OVERVIEW

1. Following a period of relative stagnation in 2001 and 2002, Mexico's economy has once again grown. While GDP rose at an annual rate of just 0.7 per cent during the period 2001-2003, partly reflecting the economic slowdown in the United States during this period, the momentum of domestic demand since then and a favourable external setting boosted growth to an annual average of 3.9 per cent from 2004 to 2006.

2. Per capita income reached a level of around US$8,000 in 2006, but only rose at an average real rate of 1.7 per cent from 2001 onwards. To raise the growth rate on a sustainable basis, additional reforms are needed to overcome problems such as inadequate infrastructure, lack of competitiveness in the domestic market and the low educational level of the workforce. Current economic conditions provide a good opportunity to address these challenges.

3. During the period under review, prudent fiscal management has resulted in progressive consolidation of the Federal public sector budget, which was in balance in 2005 and 2006; and the public debt has shrunk as a percentage of GDP. Measures are also being taken to reverse public finance's increasing reliance on oil revenues. Mexico has been successfully implementing an inflation-targeting regime, maintaining inflationary expectations around the target of 3 per cent, while lending to the private sector has increased.

4. The deficit in the balance-of-payments current account has narrowed, thanks mainly to burgeoning family remittances, despite a large deficit in the balance of trade in services. The share of merchandise trade in GDP amounted to around 60 per cent in 2006, accompanied by changes in its composition and direction. For example, oil exports have increased, reflecting the rise in international prices, although manufactures continue clearly to dominate Mexico's export basket. The United States remains Mexico's main trading partner by a wide margin; but imports from Asia, particularly from China, have also been growing rapidly.

(2) MACROECONOMIC TRENDS

(i) Structure, growth and employment

5. Mexico's GDP grew by an average of 2.3 per cent annually in real terms between 2001 and 2006, which is less than in the previous six years (4.1 per cent). The economy practically stagnated in 2001 and 2002, but growth resumed in 2003 and gathered pace to 3.9 per cent per year during the period 2004-2006. Between 2001 and 2003, the economy was hurt by a slump in external demand following consecutive contractions in industrial output in the United States and by very sluggish private investment, partly caused by a lack of progress in the regulatory reforms needed to modernize the Mexican economy.[1] The economic recovery recorded since 2004 was based on increases in private consumption and investment (domestic demand), supported by a more favourable external climate, in particular stronger demand in the United States (Table I.1).

[1] Bank of Mexico (2003 and 2004b).

Table I.1
Structure of GDP by expenditure, 2001-2007

	2001	2002	2003	2004	2005	2006	2007[a]
As a percentage of real GDP							
Total consumption	81.3	80.9	82.1	81.7	82.4	82.6	81.6
Private	71.6	71.4	72.4	72.7	73.5	73.6	73.1
Public	9.7	9.5	9.7	9.0	8.8	8.9	8.5
Total investment	19.7	19.3	19.0	19.8	20.7	21.8	22.1
Private	16.7	16.2	14.6	15.8	16.9	18.1	..
Public	3.0	3.1	4.4	4.0	3.8	3.7	..
Changes in inventory	2.2	3.1	1.4	0.8	0.5	-0.3	0.1
Exports of goods and services	33.5	34.2	34.1	36.9	38.4	40.9	40.9
Imports of goods and services	36.7	37.5	36.6	39.2	42.0	45.0	46.5
Real percentage change							
Total GDP	-0.2	0.8	1.4	4.2	2.8	4.8	2.7
Total consumption	1.9	1.4	2.1	3.6	4.6	5.1	3.4
Private	2.5	1.6	2.2	4.1	5.1	5.0	4.1
Public	-2.0	-0.3	0.8	-0.4	0.4	6.0	-2.8
Total investment	-5.6	-0.6	0.4	7.5	7.6	10.0	5.9
Private	-5.9	-4.1	-1.6	8.8	9.7	11.5	..
Public	-4.2	17.0	8.5	2.5	-0.6	2.9	..
Changes in inventory	..	..	..	..	..	..	..
Exports of goods and services	-3.6	1.4	2.7	11.6	7.1	11.1	4.0
Imports of goods and services	-1.6	1.5	0.7	11.6	8.6	12.2	6.6

.. Not available.

a Preliminary annualized figures at June 2007.

Source: Bank of Mexico and *Instituto Nacional de Estadística, Geografía e Informática* – INEGI (National Institute of Statistics, Geography and Information).

6. The faster growth of private consumption during the review period has been driven among other things by more widely available financing, an increase in the number of persons employed, and robust growth in family remittances. The expansion of gross capital formation, amounting to 22 per cent of GDP in 2006, stemmed mainly from an increase in private investment (machinery and construction), which outpaced GDP growth during the period 2004-2006.[2] Despite this, the National Infrastructure Programme for 2007-2012 recognizes that additional investments will be needed to increase productivity in the economy at large (see Chapter IV(4) and (5)).[3]

7. The manufacturing industry is a key contributor to the Mexican economy, accounting for 18 per cent of GDP. Most of its output (which includes maquila plants) is for export, with roughly 86 per cent of exported manufactures going to the United States market.[4] The scale of intra-sectoral trade in intermediate and finished goods between Mexico and its northern neighbour makes the performance of the manufacturing industry, and of the Mexican economy as a whole, particularly sensitive to business cycles in the United States.[5]

8. The industrial sector in general grew at an average real rate of 1.1 per cent annually during the period 2001-2006, accounting for one quarter of GDP in the latter year (Table I.2). The services sector expanded at an average of 3 per cent per year in real terms between 2001 and 2006, slightly increasing its share of GDP. This reflects above-average performance by the transport,

[2] Gross capital formation consists of "total investment" plus the change in inventory.
[3] National Infrastructure Programme 2007-2012. Consulted at: www.infraestructura.gob.mx.
[4] WTO Secretariat, on the basis of data from the Bank of Mexico and the United Nations Comtrade database.
[5] Robertson (2007), Bank of Mexico (2004a and 2003).

communications and financial services sectors. The agricultural sector expanded at an average real rate of 2.1 per cent over the same period, and as a result its GDP share fell back slightly.

Table I.2
Main economic indicators, 2001-2007

	2001	2002	2003	2004	2005	2006	2007[a]
I. Gross domestic product (GDP)							
GDP at current prices (Mex$ billions)	5,809.7	6,263.1	6,892.0	7,709.1	8,366.2	9,155.5	9,650.6
GDP at current prices (US$ billions)	621.8	648.6	638.8	683.1	767.7	839.9	888.1
Per capita GDP (current US$)	6,268.4	6,428.4	6,262.7	6,631.7	7,388.7	8,006.4	..
GDP share (%)							
Breakdown by sector							
Agriculture	5.2	5.1	5.3	5.2	5.0	5.0	5.0
Industry	25.6	25.3	24.8	24.9	24.7	24.8	24.5
Services	64.0	64.4	65.0	65.1	65.7	65.6	66.8
Taxes less imputed bank service charges	5.2	5.2	4.9	4.8	4.6	4.6	3.8
Real growth rates (%)							
Total GDP	-0.2	0.8	1.4	4.2	2.8	4.8	2.7
Breakdown by sector							
Agriculture, forestry and fisheries	3.5	0.1	3.1	3.5	-2.1	4.8	2.0
Industrial sector	-3.5	-0.1	-0.2	4.2	1.7	5.0	0.7
Mining	1.5	0.4	3.7	3.4	2.1	2.2	1.0
Manufacturing	-3.8	-0.7	-1.3	4.0	1.4	4.7	0.2
Construction	-5.7	2.1	3.3	6.1	3.3	6.9	1.6
Electricity, gas and water	2.3	1.0	1.5	2.8	1.7	5.0	4.1
Services	1.2	1.6	2.1	4.4	4.0	4.9	3.7
Commerce, restaurants and hotels	-1.2	0.0	1.5	5.5	2.7	3.7	1.9
Transport, storage and communication	3.8	1.8	5.0	9.2	7.1	9.1	7.3
Financial, insurance and real estate services	4.5	4.2	3.9	3.9	5.8	5.4	4.8
Community, social and personal services	-0.3	0.9	-0.6	0.6	1.8	2.8	2.0
Imputed bank service charges	6.5	7.6	7.1	7.5	10.9	8.5	..
Product taxes net of subsidies	0.0	0.8	1.4	4.2	2.8	4.8	..
II. Employment							
Open unemployment rate[b] (%)	2.4	3.0	3.4	3.9	3.6	3.6	3.9[c]
Population (millions)	99.2	100.9	102.0	103.0	103.9	104.9	..

.. Not available.

a Preliminary annualized figures at June 2007.
b Unemployed population as a percentage of the economically active population (EAP) at year end; i.e. the percentage of the EAP that was unemployed in the reference period, but which had searched for work in the final month.
c At September 2007.

Source: Bank of Mexico and INEGI.

9. The stronger pace of economic activity since 2003 has been accompanied by an increase in employment (about 10 per cent mainly in the formal sector of the economy). Nonetheless, this has not been fully reflected in a lower rate of open unemployment because a larger number of individuals, mostly women, entered the economically active population.[6] It is estimated that about 27 per cent of the employed population is working in the informal sector.[7] A report by the Organisation for Economic Co-operation and Development (OECD) suggests that the decision by entrepreneurs not to set up formal businesses is a result of excessive regulation and the high costs imposed by mandatory social welfare contributions.[8]

[6] Bank of Mexico (2004b and 2006a).
[7] First Government Report of 1 September 2007. Consulted at: http://www.informe.gob.mx/pdf_excel/M100-105.pdf.
[8] OECD (2005).

10. Per capita GDP (in United States dollars) grew at an average real rate of 1 per cent over the period 2001-2006, to reach a level of US$8,007 in the latter year.[9] Nonetheless, roughly half the population was still living in poverty, and 17 per cent in conditions of food poverty in 2004 (the latest year for which figures are available).[10]

11. In its most recent study of the Mexican economy, the OECD notes that while the country has made significant progress towards macroeconomic stability, potential GDP growth has been too low either to close the living-standards gap with respect to the more advanced OECD countries, or to address the persistent problem of extensive poverty.[11] The study therefore considers that additional reforms are needed over a wide range of areas in order to move the economy towards a higher and sustainable growth path (Box I.1). Another study by the International Monetary Fund (IMF) proposes a number of changes needed to secure the transition to faster growth, including reforms to improve access to credit, promote a more efficient and dynamically functioning market, and strengthen the business climate.[12]

Box I.1: Reforms recommended by the OECD

The OECD notes that the reform process, which has lost momentum in recent years, should gather pace as a result of a number of measures, including greater economic openness to make the most of international integration. The OECD suggests prioritizing the following reforms:

- Further liberalize international trade by lowering the most-favoured-nation (MFN) tariff so as to give firms better access to competitive inputs and restrict possibilities for corruption and fraud at the country's borders. Also, further reduce non-tariff barriers, e.g. complex customs procedures and complicated technical requirements.
- Further encourage investment, by reducing restrictions on foreign direct investment (FDI) in sectors such as telecommunications, land transport, coastal shipping and airports; and support that openness with improvements in the business climate and additional strengthening of the rule of law.
- Strengthen public finances by taking steps to increase the efficiency of public spending; facilitate the fight against tax evasion; replace oil revenues with more stable income sources; reduce the subsidies that still prevail in areas such as water, electricity and gasoline; restrict the numerous exemptions or special regimes; and analyse fiscal relations between the various levels of government.
- Increase competitiveness and enforce competition policy so as to promote productivity and growth in services such as natural gas, electricity, airports, railways and telecommunications.
- Raise the low level of human capital and labour market adaptation capacity by taking steps to reduce inefficiency in the education sector, strengthen incentives for teachers to perform more effectively, and make renewed efforts to develop skills among adults.

Source: WTO Secretariat, information based on OECD (2007).

(ii) Fiscal policy

12. The non-financial public sector (NFPS) saw a gradual improvement in its financial indicators over the period 2001-2006 and achieved a balanced budget in 2005 and 2006 (Table I.3). During this period, spending rose in nominal terms and in relation to the GDP, but at a lower rate than income. Some of the spending that increased the most were other current expenditures (mainly outsourced services), public investment in infrastructure and contributions to stabilization funds (such as the *Fondo de Estabilización de Ingresos de las Entidades Federativas* (Federative Entity Income

[9] The growth of real GDP per capita was calculated by the WTO Secretariat on the basis of 1993 prices and population data published by the INEGI.

[10] Conditions of food poverty means living with less than what is needed to acquire minimally acceptable nourishment. Consulted at: http://www.sedesol.gob.mx/archivos/70/File/2as_ Docu24.pdf.

[11] OECD (2007c).

[12] IMF (2006c).

Stabilization Fund), the PEMEX *Fondo de Estabilización para la Inversión en Infraestructura* (Infrastructure Investment Stabilization Fund), and the *Fondo de Estabilización de los Ingresos Petroleros* (Oil Revenue Stabilization Fund). In addition, the fastest-growing income categories were those linked to petroleum, mainly reflecting the rising price of oil on world markets; and value-added tax (VAT) as a result of more vigorous growth in private consumption. Oil revenues accounted for 34 per cent of total Federal public sector income on average between 2001 and 2006, reaching a maximum share of 38 per cent in the latter year.

Table I.3
Balance of the Federal non-financial public sector (NFPS), 2001-2007
(% of GDP)

	2001	2002	2003	2004	2005	2006	2007[a]
A. Budgetary income	**21.9**	**22.1**	**23.2**	**23.0**	**23.3**	**24.7**	**24.8**
Oil revenues	6.7	6.5	7.7	8.3	8.7	9.4	8.2
PEMEX[b]	1.8	2.4	2.5	2.5	2.2	3.5	3.3
Federal Government (taxes and duties)	4.9	4.1	5.2	5.8	6.5	5.9	5.0
Non-oil income	15.2	15.6	15.5	14.7	14.6	15.3	16.6
Federal Government	11.3	11.6	11.2	10.7	10.4	11.1	12.6
Tax income	9.8	9.8	9.8	9.3	9.5	10.1	11.5
Income tax (ISR)	4.9	5.1	4.9	4.5	4.6	4.9	5.9
Value-added tax (VAT)	3.6	3.5	3.7	3.7	3.8	4.1	4.3
Import duties	0.5	0.4	0.4	0.4	0.3	0.3	0.3
IEPS[c]	0.4	0.4	0.4	0.4	0.4	0.4	0.5
Other	0.4	0.4	0.4	0.3	0.4	0.4	0.5
Non-tax income	1.5	1.8	1.4	1.4	0.9	0.9	0.6
State-owned enterprises and entities[d]	3.9	4.0	4.2	4.0	4.2	4.2	..
B. Budgetary expenditure	**22.6**	**23.3**	**23.9**	**23.2**	**23.4**	**24.6**	**22.4**
Programmable expenditure	15.9	16.9	17.6	17.1	17.4	18.1	15.8
Current expenditure	13.3	13.8	14.6	13.5	14.0	14.4	13.5
Personal services	7.3	7.6	7.3	6.7	6.7	6.7	..
Materials and supplies	1.5	1.3	1.7	1.6	1.7	1.7	..
Subsidies and transfers[e]	2.1	2.2	2.3	2.3	2.4	2.4	..
Other current expenditure	2.4	2.6	3.2	2.9	3.3	3.6	..
Capital expenditure	2.6	3.2	3.0	3.5	3.4	3.7	2.3
Physical investment	2.4	2.4	2.7	3.0	2.8	3.0	..
Financial investment and other expenditure	0.2	0.8	0.3	0.6	0.6	0.7	..
Non-programmable expenditure	6.6	6.4	6.3	6.2	6.0	6.5	6.6
Financial expenditure	3.2	2.8	2.8	2.7	2.5	2.7	..
Interest payments	2.9	2.5	2.3	2.3	2.0	2.1	..
Federal Government	2.2	1.8	1.9	1.7	1.7	1.7	..
State-owned enterprises and entities	0.7	0.7	0.4	0.6	0.3	0.4	..
Subsidies and assistance to debtors	0.4	0.3	0.5	0.4	0.5	0.6	..
Revenue sharing with states and municipalities	3.4	3.4	3.3	3.1	3.3	3.6	..
Arrears and other expenditure	0.0	0.1	0.2	0.4	0.1	0.2	..

Table I.3 (cont'd)

	2001	2002	2003	2004	2005	2006	2007[a]
C. Budget surplus/deficit (A - B)	**-0.7**	**-1.2**	**-0.7**	**-0.3**	**-0.1**	**0.1**	**2.4**
Memorandum item:							
Total public sector funding requirements[f]	-3.8	-3.2	-3.2	-2.5	-1.9	-1.3	..
Total net debt of the public sector[g]/GDP	36.6	40.2	37.9	34.9	32.4	33.4	..
Net external public debt (US$ millions)	74,743	73,423	74,723	76,304	69,501	48,592	..

.. Not available.

a Preliminary figures at June 2007 (calculated on the basis of half of annualized GDP at June 2007).
b Petróleos Mexicanos.
c Special Tax on Production and Services.
d Excludes contributions to the *Instituto de Seguridad y Servicios Sociales para los Trabajadores del Estado* – ISSTE (Institute of Social Welfare and Services for State Employees).
e Includes subsidies and transfers apart from those recorded under other headings.
f Excludes exceptional or non-recurrent income.
g Includes net liabilities of the Federal Government, the parastatal sector, official financial intermediaries (development banks and official trust funds), IPAB, PIDIREGAS projects and debtor support programmes; but excludes the financial balance of the Bank of Mexico.

Source: WTO Secretariat, on the basis of data from the Ministry of Finance and Public Credit (SHCP) and the Bank of Mexico.

13. The Bank of Mexico has commented that the increasing reliance of public finances on oil revenues reflects both the additional revenues obtained from higher oil prices and weak tax collection in the non-oil sector.[13] It has also pointed out that this reliance reveals the vulnerability of public finances, highlighting the following risk factors: (i) while public expenditure has grown, non-oil tax revenue has not shown any significant increase; (ii) additional oil revenues have mostly been used to finance higher levels of expenditure, particularly current spending; (iii) the PEMEX crude oil production platform has started to shrink as a result of a lack of investment in exploration (see Chapter IV(4)); and (iv) the volatility of oil prices means that public finances could be facing uncertain scenarios in years to come.

14. The total public sector funding requirement gradually decreased during the review period (Table I.3). This broad indicator mainly includes the NFPS budget balance, liabilities of the *Instituto para la Protección al Ahorro Bancario* – IPAB (Institute for the Protection of Bank Savings), and liabilities generated by PIDIREGAS-funded investment projects (see Chapter IV(4)).

15. The net total debt of the public sector decreased by almost seven percentage points in relation to GDP between 2002 and 2006, to reach a level of 33.4 per cent by the end of that period. According to the IMF, while this level is not high by international standards, it would be prudent to lower it further given the instability of oil revenues.[14] Since 2002, when international risk rating agencies accorded investment grade to Mexico's sovereign debt profile, the authorities have consolidated the process of replacing external borrowing with domestic debt, while also lengthening the average maturity on its debt securities.

16. Fiscal policy in Mexico is formulated by the SHCP. In 2006, the country's tax legislation was reformed through the Federal Budget and Treasury Accountability Law (LFPRH)[15], which requires the SHCP to submit the Revenue and Expenditure Budget Law for approval by Congress each year. While this should generally aim to maintain a balanced NFPS budget, exceptionally and depending on the circumstances, the SHCP may propose a deficit (or surplus) budget, provided it explains to

[13] Bank of Mexico, Inflation Report, October-December 2006, and Monetary Programme for 2007. Consulted at: http://www.banxico.org.mx/documents/{4B1E8447-E248-5DCF-7E81-966E58D 178E7}.pdf.
[14] IMF (2006c).
[15] The most recent reform was published in the Official Journal of the Federation of 1 October 2007.

Congress the exceptional reasons justifying this and indicates the number of fiscal years and actions required to restore fiscal balance.

17. The LFPRH requires each Revenue and Expenditure Budget Law to specify the value of oil revenues for the fiscal year in question. It establishes that surplus revenues, e.g. those resulting from higher-than-projected oil prices, should be used to cover non-programmable expenditure, shared among the different stabilization funds and infrastructure projects. Should petroleum revenues prove less than expected owing to a fall in oil prices during the fiscal year, the appropriate stabilization funds may be drawn down; but when these run out, expenditure cuts become necessary. The LFPRH also provides for adjustment mechanisms should non-oil income drop below the programmed level.

18. To reduce the reliance of public finances on oil revenues, a fiscal reform was approved in 2007 that seeks, *inter alia,* to reduce current expenditure by the Federal Government and increase tax revenues that are more stable than oil income. It is hoped that such incomes will grow by roughly 2.1 per cent of GDP until 2012, as a result of: collection of the new flat rate business tax (IETU); increase of the Special Tax on Production and Services (IEPS) applied on gasoline and diesel sales; and more efficient collection of income-tax (ISR) and VAT.[16] The authorities also intend to reduce ISR and VAT tax evasion, which was estimated at 3 per cent of GDP in 2003, by strengthening auditing processes and introducing a new tax on cash deposits – the latter with the aim of detecting and discouraging informal activity. The reform also made further alterations to the PEMEX fiscal regime, reducing the tax burden on this company and consequently its tax contributions.[17]

(iii) Monetary and exchange-rate policy

19. The Bank of Mexico is the authority responsible for formulating monetary and exchange-rate policies in Mexico. The Constitution gives the Bank autonomy to exercise its functions and establishes that its prime objective is to maintain the purchasing power of the local currency.

20. Up to 2004, the Bank of Mexico used the *"corto"* mechanism as the main instrument for altering its monetary stance, under which it would define the amount of credit to be auctioned to banks each day, so as to attain the target balance pre-established in the *"corto"*. This represented the cumulative daily balance of accounts held by other banks with the Bank of Mexico. In the second quarter of 2004, the latter introduced amendments to complement the announcement of the level of the "*corto*" in its monetary policy communiqués, and thus provide more precise signals to markets on domestic monetary conditions and the desired monetary position.

21. The Bank of Mexico has announced that the *"corto"* will be replaced in January 2008 by a target rate for overnight bank funding operations. The move to an operational interest rate target will be implemented without altering the inflation targeting regime or the way the Bank of Mexico carries out its operations. The change seeks to make monetary policy actions easier to understand, and bring their implementation into line with that of various central banks around the world.[18]

22. The Bank of Mexico conducts monetary policy so as to attain an annual inflation rate of 3 per cent as measured by the national consumer price index (INPC), and to keep it within a range of plus

[16] SHCP Press Communiqué No. 081 of 16 September 2007. Consulted at: http://www.shcp.gob.mx/.

[17] SHCP (2007a).

[18] Bank of Mexico, Monetary Policy Regime and Inflation Report, July-September 2007. Consulted, respectively, at: http://www.banxico.org.mx/polmoneinflacion/didactico/regimenPM/RegimenPoliticaMonetaria.pdf and http://www.banxico.org.mx/publicaciones/JSP/b_informeInflacion.jsp.

or minus one percentage point of that level.[19] The IMF considers that the inflation targeting regime has been successfully implemented[20]; although the inflation target was surpassed in 2002, 2004 and 2006 (Table I.4), the Fund argues that the monetary authority's credibility has increased, and since 2003 inflationary expectations have remained around the 3 per cent target.[21]

Table I.4
Main monetary indicators, 2001-2007

	2001	2002	2003	2004	2005	2006	2007[a]
Monetary aggregates							
Monetary base (Mex$ millions)	225,580	263,937	303,614	340,178	380,034	449,821	412,441
Monetary base (% real annual variation)[b]	5.4	11.4	10.7	8.8	7.9	12.4	-8.3
M1 (% real annual variation)[b]	8.2	12.9	7.0	8.8	6.9	11.6	..
M4 (% real annual variation)[b]	7.0	6.1	6.6	7.5	10.4	10.6	..
Interest rates (annual average %)							
Cetes at 28 days[c]	11.31	7.09	6.23	6.82	9.20	7.19	7.13
TIIE at 28 days[d]	12.89	8.17	6.83	7.15	9.61	7.51	7.93
20-year Treasury bond rate (fixed rate)	n.a.	n.a.	8.39	10.45	9.81	8.55	7.77
Inflation (12 month % rate of change, end of period)							
Inflation target[e]	6.50	4.50	3.00	3.00	3.00	3.00	3.00
National consumer price index (INPC)	4.40	5.70	3.98	5.19	3.33	4.05	3.79
National producer price index (INPP)[f]	2.61	6.29	6.24	7.97	2.46	7.12	3.22
Exchange rates							
End of period exchange rate (Mex$/US$)	9.14	10.31	11.24	11.27	10.77	10.88	10.87
Real effective exchange rate (1990=100)[g]	62.8	61.1	71.8	77.3	73.9	73.0	..

n.a. Not applicable.

.. Not available.

a Preliminary figures at September 2007.
b Calculated on the basis of average balances at the end of each month.
c Annual average of rates on 28-day Federation Treasury Certificates.
d Annual average of 28-day Equilibrium Interbank Interest Rates.
e Plus or minus one percentage point of variability.
f Excludes oil.
g Estimated on the basis of consumer prices and with respect to a basket of 111 countries weighted by their respective GDPs.

Source: Bank of Mexico.

23. The authorities pointed out that the rise in prices recorded in 2004 was the result of external shocks, particularly the surge in energy prices, whereas the increase in 2006 was caused by supply disturbances affecting a small group of goods and services, including tortillas and sugar.[22]

24. The monetary base expanded at an annual average rate of 14.8 per cent over the period 2001-2006, largely reflecting the acceleration of economic growth (Table I.4).

25. Between 2001 and 2006, interest rates tended to fall, albeit with fluctuations (Table I.4); and since 2004 the spread between short and long-term rates has narrowed. Since 2003, there has been a sharp increase in lending to the private sector, which grew by roughly 162 per cent in real terms between 2003 and 2006, expanding its GDP share from 2.1 per cent to 4.6 per cent in that period.

[19] Bank of Mexico, Monetary Policy Regime. Consulted at: http://www.banxico.org.mx/polmoneinflacion/didactico/regimenPM/RegimenPoliticaMonetaria.pdf.
[20] IMF (2006c).
[21] *Ibid.*
[22] Bank of Mexico (2004b and 2006a).

Nonetheless, access to private sector credit for private individuals remains relatively weak, amounting to no more than about 14 per cent of GDP in 2006.[23]

26. Exchange-rate policy is the responsibility of the Foreign Exchange Committee, which consists of officials from the SHCP and the Bank of Mexico. In late 1994, the Committee decided to allow the exchange rate to be determined freely by market forces; and under this regime, between late 2001 and mid-2004, the exchange rate depreciated by up to 26 per cent. Since late 2004, however, it has appreciated slightly, reaching a level of around Mex$10.9 per United States dollar in late 2006 (Table I.4). The real effective exchange rate behaved in a similar way during the period under review.

27. In March 2003, the authorities defined a mechanism for managing international reserves for the purpose of stabilizing and reducing the rate at which these are accumulated by the Bank of Mexico, without affecting the free flotation of the exchange rate.

(iv) Balance of payments

28. As in previous periods, the balance-of-payments current account was in deficit throughout the period 2001-2006, although it was clearly decreasing (Table I.5). The current account deficit shrank from 2.8 per cent of GDP in 2001 to 0.2 per cent in 2006, reflecting a narrowing of the trade deficit and, particularly, a substantial increase in family remittances. Growth in oil exports is the main factor driving the two balance-of-payments improvement cycles. Nonetheless, the first cycle (2001-2003) was also assisted by flat domestic aggregate demand; and the second (2004-2006) was supported by an increase in external demand for Mexican non-oil products.

29. The deficit in the services balance is considerably larger than the overall trade deficit (Table I.5), having remained broadly stable during the review period, albeit with a fall in 2004 and a rise in 2006. The former was mainly due to growth of "Other factor income". The 2006 increase in particular reflected slower growth of domestic tourism and a continuous increase in imports of freight and insurance services (see section (3)(ii) below).

30. The value of family remittances registered exceptionally strong growth, averaging 21 per cent per year between 2001 and 2006. Preliminary data for 2007 indicate a slowdown, however. Growth in the amount of family remittances recorded by the Bank of Mexico is mainly explained by an increase in the number of Mexican immigrants in the United States; but additional contributory factors were lower costs and government measures encouraging the use of formal fund transmission channels (e.g. electronic transfers). Although remittances only represented 2.8 per cent of GDP in 2006, they are important for the current account balance and for the growth of Mexico's economy. The IMF has noted that various studies show that remittances have helped to reduce poverty in Mexico as resources of this type seem to be channelled towards consumption and, to a much smaller extent, to investment in microenterprises.[24]

Table I.5
Balance of payments, 2001-2007
(US$ millions)

		2001	2002	2003	2004	2005	2006	2007[a]
I.	**Current account**	**-17,683**	**-14,109**	**-8,851**	**-6,690**	**-4,897**	**-1,771**	**-3,395**
I.1	**Trade balance**	**-9,617**	**-7,633**	**-5,779**	**-8,811**	**-7,587**	**-6,133**	**-5,007**
	Exports of goods[b]	158,780	161,046	164,766	187,999	214,233	249,997	127,945
	Imports of goods[b]	168,396	168,679	170,546	196,810	221,820	256,130	132,952

Table I.5 (cont'd)

[23] Bank of Mexico (2004b, 2005 and 2006a).
[24] IMF (2006b).

		2001	2002	2003	2004	2005	2006	2007[a]
I.2	**Balance of trade in services**	**-17,404**	**-16,744**	**-16,930**	**-14,922**	**-17,795**	**-19,090**	**-10,457**
	Factor services, net	-13,846	-12,696	-12,329	-10,315	-13,082	-12,990	-7,985
	Income	5,366	4,099	3,942	5,708	5,938	6,691	3,590
	Interest	4,075	2,835	2,343	2,211	3,011	4,444	2,658
	Factor services, other	1,292	1,263	1,599	3,497	2,927	2,247	932
	Outflows	19,213	16,795	16,271	16,024	19,020	19,682	11,575
	Interest	12,693	11,966	11,670	11,222	12,260	13,700	7,247
	Profits remitted and reinvested	5,544	3,909	3,593	3,584	6,100	5,006	3,774
	Other	976	920	1,008	1,217	661	976	554
	Non-factor services, net	-3,558	-4,048	-4,601	-4,607	-4,713	-6,099	-2,472
	Income	12,660	12,692	12,533	13,955	16,066	16,265	8,873
	Outflows	16,218	16,740	17,134	18,562	20,779	22,364	11,345
I.3	**Transfers**	**9,338**	**10,268**	**13,858**	**17,044**	**20,484**	**23,452**	**12,068**
	Family remittances	8,895	9,814	13,396	16,613	20,035	23,054	11,859
	Other, net	443	454	462	431	449	398	209
II.	**Capital account**	**26,000**	**27,018**	**22,254**	**11,835**	**12,692**	**1,834**	
	Liabilities	29,835	15,175	14,790	23,600	26,884	14,928	22,563
	Loans and deposits	1,256	-4,213	-1,334	-1,372	543	-10,488	3,334
	Public sector	-1,294	-4,464	-4,332	-4,440	-10,093	-22,027	313
	Private sector	-870	-5,021	-3,205	-2,881	1,887	4,514	2,324
	PIDIREGAS	3,420	5,272	6,203	5,949	8,749	7,026	697
	Foreign direct investment	27,487	19,342	15,345	22,301	19,643	18,938	13,244
	Portfolio investment	1,092	46	779	2,671	6,699	6,477	5,985
	Assets	-3,835	11,844	7,464	-11,765	-14,193	-13,094	-15,444
	In banks abroad	-1,512	10,773	7,457	-5,579	-4,403	-7,889	..
	Direct investment by Mexican nationals	-4,404	-891	-1,253	-4,432	-6,474	-3,897	..
	Other assets	2,081	1,961	1,261	-1,754	-3,316	-1,308	..
III.	**Errors and omissions**	**-993**	**-5,820**	**-3,965**	**-1,087**	**-630**	**-1,067**	**-1,467**
IV.	**Variation in net reserves**	**7,325**	**7,104**	**9,451**	**4,061**	**7,173**	**-989**	**2,260**
Memorandum item:								
International reserves		40,880	47,984	57,435	61,496	68,669	67,680	69,939
International reserves (months of merchandise imports)		2.9	3.4	4.0	3.7	3.7	3.2	3.2
Current account as a percentage of GDP		-2.8	-2.2	-1.4	-1.0	-0.6	-0.2	-0.4
Total gross external debt of the public and private sectors (as a percentage of GDP)		25.3	23.9	24.7	23.7	21.5	19.0	14.0

.. Not available.

a Preliminary figures at June 2007.
b F.o.b. values, including maquila enterprises.

Source: WTO Secretariat, on the basis of data from the Bank of Mexico.

31. Capital account items that have made a net positive contribution to the balance of payments include FDI flows and funding through the PIDIREGAS schemes (see Chapter IV(iv)). Net negative contributions include flows generated by external public debt amortization.

32. Capital account surpluses were more than sufficient to finance the current account deficit during the period 2001-2005, so there were consecutive increases in the international reserves held by the Bank of Mexico. The IMF considers the level of international reserves to be reasonably adequate for the Mexican economy;[25] and in 2006 these were broadly unchanged as other items in the balance of payments were practically in balance.

33. Mexico's total gross external debt averaged around US$160 billion over the period 2001-2006, but fell steadily in relation to GDP to reach a level of 19 per cent at the end of that period

[25] IMF (2005).

(Table I.5). The main reason for this decrease was a reduction in the gross external debt of the public sector, while gross private external debt remained at around 12 per cent of GDP.[26]

(3) DEVELOPMENTS IN TRADE AND INVESTMENT FLOWS

(i) Trade in goods[27]

34. Mexico's total trade in goods (imports plus exports) expanded from 52.6 per cent of GDP in 2001 to 60.3 per cent in 2006 – a relatively high proportion compared to other economies of similar size. In 2006, imports accounted for 30.5 per cent of GDP while exports represented 29.8 per cent.

(a) Composition of trade in goods

35. Exports of goods were valued at US$250,256 million in 2006 (Table AI.1), having grown at an annual average rate of just 2 per cent between 2001 and 2003, but accelerating to 15 per cent between 2004 and 2006. Although oil exports saw their value and share of total merchandise exports double between 2001 and 2006, to reach a level of 15 per cent in the latter year, exports of manufactures continued to be the most important category, representing on average 80.5 per cent of the total. Although the value of exports of manufactures grew from 2004 onwards, their percentage share of the total declined from 2001 to 2006. These include categories encompassing television sets and motor vehicles for passenger transport.

36. Data from the Bank of Mexico show that maquila enterprises accounted for 55 per cent of all exports of manufactures, while the automotive sector was responsible for most non-maquila exports.[28]

37. Imports of goods amounted to US$256,086 million in 2006 (Table AI.2), having grown at an annual average rate of 0.6 per cent between 2001 and 2003, but at 14.5 per cent between 2004 and 2006. Imports of products from the extractive industries, mainly non-ferrous metals and fuels, grew faster than the average for imports generally, to gain an 8.8 per cent share in 2006. The manufactures category includes imports of aluminium parts and articles, and other motor vehicle spares and parts.

38. The Bank of Mexico reports that intermediate goods accounted for an average of 75 per cent of all imports during the period 2001-2006, of which 45 per cent were imported by maquila enterprises.[29]

(b) Direction of trade in goods

39. Mexico's exports of goods are mainly to the United States market, which absorbed 87.5 per cent of the total on average between 2001 and 2006. During that period, the nominal value of Mexico's exports to the United States increased by 51 per cent, although their share of the country's total exports fell from 88.7 per cent to 84.8 per cent. Between 2002 and 2006, the share of Mexican exports in the United States' total imports also fell, from 11.6 per cent to 10.7 per cent, owing to the rapid expansion of United States purchases from countries such as China.[30] In addition, the relative importance of Mexican exports to Europe, particularly the European Communities, and Asia, has increased, although as a whole they accounted for just 7 per cent of total exports in 2006.

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[26] Bank of Mexico (2006a).

[27] The data reported in this section come from the United Nations Comtrade database and are classified according to the SITC (Rev 3).

[28] Bank of Mexico (2006a).

[29] *Ibid*.

[30] *Ibid*.

40. The available statistics may not fully reflect the real importance of certain partners in Mexico's trade, mainly because of the large proportion that is transported through the United States. For example, using data on imports from Mexico recorded by third countries, instead of those registered as exports by Mexico, suggests that the value of Mexican sales to Canada, China, the European Communities, the Republic of Korea and Japan could each be underestimated by between 30 and 180 per cent.

41. The origin of the goods imported by Mexico has diversified considerably, with the leading source, the United States, dropping from 67.7 per cent in 2001 to 51.1 per cent in 2006 (Table AI.4). Although the share of other countries on the American continent and in the European Communities grew from 2001 to 2006, the share accounted for by Asian countries expanded faster. Imports from China and the Republic of Korea, in particular, grew at an average nominal rate of 43 per cent and 25 per cent, respectively, during that period. Imports from China are mainly concentrated in product groups corresponding to telecommunications and office parts and equipment, and other electrical machinery. The authorities have pointed out that most of these represent intermediate inputs that enhance the competitiveness of the Mexican production sector.

(ii) Trade in services

42. The services balance maintained its traditional deficit between 2001 and 2006. Despite natural phenomena that affected some of Mexico's tourist regions, the tourism balance remained positive in that period, growing cumulatively by about 50 per cent (Table I.6). Imports of freight and insurance services expanded at an average annual rate of 10 per cent between 2001 and 2006, reflecting the total predominance of the foreign merchant fleet in providing international transport services in Mexico, together with the growth of Mexico's external trade (see Chapter IV(5)(v)).

Table I.6
Trade in services, 2001-2007
(US$ millions)

	2001	2002	2003	2004	2005	2006[a]	2007[b]
Balance of non-factor services	**-3,558**	**-4,048**	**-4,601**	**-4,607**	**-4,713**	**-6,099**	**-2,472**
Non-factor income	12,660	12,692	12,533	13,955	16,066	16,265	8,873
Transport services, various	1,282	1,143	1,113	1,362	1,753	1,947	..
Tourism	8,401	8,858	9,362	10,796	11,803	12,177	6,861
Other non-factor services	2,978	2,691	2,059	1,798	2,510	2,142	2,012[c]
Outlays on non-factor services	16,218	16,740	17,134	18,562	20,779	22,364	11,345
Freight and insurance	4,643	4,408	4,493	5,450	6,494	7,418	3,917
Transport services, various	2,105	1,990	1,930	2,127	2,716	2,744	..
Tourism	5,702	6,060	6,253	6,959	7,600	8,108	3,936
Other non-factor services	3,767	4,283	4,457	4,025	3,969	4,094	3,491[c]

.. Not available.

a Preliminary figures.
b Preliminary figures at June 2007.
c Includes the category "Transport services, various".

Source: Bank of Mexico.

(iii) Foreign direct investment

43. Foreign direct investment (FDI) flows behaved irregularly throughout the period 2001-2006, in which FDI flows to Mexico totalled just over US$124 billion (equivalent to an annual average of US$20.667 billion, or 3 per cent of GDP). Of that amount, roughly 45 per cent went to the

manufacturing sector, with 29 per cent and 9 per cent channelled to the financial sector and the social, professional and tourism services sector, respectively (Table I.7).

Table I.7
Foreign direct investment (FDI) by sector, 2001-2007
(US$ millions)

Sector	2001	2002	2003	2004	2005	2006	2007[a]
Total	**29,431**	**21,097**	**15,007**	**22,470**	**19,881**	**16,119**	**9,444**
Agriculture and fisheries	64	93	11	17	4	19	-9.6
Mining and oil extraction	22	248	80	146	69	323	676
Manufacturing industries[b]	5,789	8,651	6,821	12,756	11,565	9,270	4,170
Electricity and water	333	398	322	202	192	-97	-28
Construction	108	349	81	390	282	351	159
Commerce	2,250	1,778	1,398	1,211	2,680	344	838
Transport and communications	2,782	1,593	1,631	1,254	1,427	385	364
Financial services[c]	16,424	6,740	2,830	5,575	1,148	2,725	2,736
Social, professional and tourism services[d]	1,659	1,247	1,833	918	2,513	2,799	539

a Preliminary figures at June 2007.
b Includes maquila enterprises.
c Financial services, administration and rental of movable and immovable property.
d Community and social services; professional, technical and personal services; hotels and restaurants.

Note: As from 1999, includes items of new investment other than equity, reinvestment of profits and inter-company accounts that have been notified to the *Registro Nacional de Inversiones Extranjeras* – RNIE (National Register of Foreign Investment). Excludes estimated FDI undertaken but not yet notified to the RNIE.

Source: Directorate General of Foreign Investment of the Ministry of the Economy.

44. The main FDI sources during this period were the United States, which accounted for around 59 per cent of total FDI flows, and the European Communities (33 per cent), led by Spain and the Netherlands (Table I.8).

Table I.8
Foreign direct investment (FDI) by country of origin, 2001-07
(US$ millions)

Country	2001	2002	2003	2004	2005	2006	2007[a]
Total	**29,431**	**21,097**	**15,007**	**22,470**	**19,881**	**16,119**	**9,444**
United States	21,385	12,919	9,615	8,291	10,240	10,280	5,730
EC (25)	6,171	6,722	4,303	11,870	6,008	5,915	2,352
Spain	2,716	2,545	1,296	7,434	1,454	614	1,311
Netherlands	2,598	1,475	692	3,325	2,325	2,991	357
United Kingdom	132	1,249	1,074	138	968	775	42
Germany	-109	596	463	399	347	82	36
France	393	350	535	157	452	693	279
Canada	992	221	258	475	301	516	78
Switzerland	(176)	462	286	1,124	160	356	22
Japan	188	166	122	363	88	(1,496)	58
Other	1,420	1,115	699	472	3,479	1,290	1,204

a Preliminary figures at June 2007.

Note: As from 1999, includes items of new investment other than equity, reinvestment of profits and inter-company accounts that have been notified to the RNIE. Excludes estimated FDI undertaken but not yet notified to the RNIE.

Source: Directorate General of Foreign Investment of the Ministry of the Economy.

(4) OUTLOOK

45. The SHCP is forecasting real GDP growth of 3.3 per cent in 2007 and 2.8 per cent in 2008[31], with fiscal accounts remaining in balance in 2007 and in 2008, leading to a strengthening of Federal Government debt indicators. The SHCP also predicts a balance-of-payments current account deficit equivalent to 0.8 per cent of GDP in 2007, partly as a result of annual growth in the value of exports and imports of goods and services of 5.1 per cent and 6.2 per cent, respectively.[32]

46. The SHCP expects inflation to be 3 per cent in 2007 and 3.7 per cent in 2008, as measured by the INCP, thus remaining within the range of variability stipulated by the Bank of Mexico. Interest rates (28-day Cetes) are forecast to be 7.2 per cent by the end of 2007, and 7 per cent at the end of 2008. The SHCP also expects the average oil price to drop to around US$54.6 a barrel in 2007 and US$46.6 a barrel in 2008; and it foresees a slight depreciation of the Mexican peso against the United States dollar, with the exchange rate around 11 pesos per dollar at the end of 2007 and 11.2 by the end of 2008.[33]

[31] Statement by the Under-Secretary of the SHCP. Consulted at: http://www.shcp.gob.mx.

[32] Draft Federal Revenues Law for the Fiscal Year 2008 (SHCP). Consulted at: http://www.apartados.hacienda.gob.mx/presupuesto/temas/ppef/2008/temas/expo_motivos/ingresos/ilif_2008.pdf.

[33] Draft Federal Revenues Law and Expenditure Budget for 2008, published by the SHCP on 3 October 2007. Consulted at: http://www.apartados.hacienda.gob.mx/novedades/espanol/docs/2007/Presentaciones/presentacion_secretario_paqueteconomico_03102007.pdf.